ENVIRONMENTAL FINANCIAL ADVISORY BOARD

May 30, 2006

Honorable Stephen L. Johnson
Administrator
U.S. Environmental Protection Agency
1200 Pennsylvania Avenue NW.
Washington, DC 20460

Dear Administrator Johnson:

The Environmental Financial Advisory Board is pleased to submit the enclosed report, "Establishment of a New State Revolving Fund Loan Guaranty Program" for the Agency's consideration and use. To date, the Board has not identified an area in which a significant benefit would be realized from the establishment of a new loan guaranty program.

The Board's deliberations focused on the potential benefits of creating a new guaranty program, as contrasted with what can be achieved under existing legislation. In evaluating the potential incremental benefit of a new loan guaranty program, the Board's primary consideration was whether a new program would stimulate or accelerate environmental activity. A secondary consideration was whether a new program would increase the amount of private money involved in supporting environmental programs. In general, the benefits that could be achieved through the creation of new loan guaranty program could also be achieved using the existing loan guaranty programs.

However, two areas may warrant further study. First, consideration might be given as to whether existing loan guaranty authority for environmental programs could be more effectively leveraged. Second, additional consideration might be given as to whether a new loan guaranty program targeted at small, unrated borrowers could accelerate environmental activity in that sector.

The Board appreciates the continuing opportunity to provide financial advisory assistance to the Agency on issues of national importance.

Sincerely,

A. Stanley Meiburg
Executive Director

Enclosure

cc: Ben Grumbles, Assistant Administrator for Water
Lyons Gray, Chief Financial Officer

EFAB Report on Establishing a New
SRF Loan Guaranty

Question

Should the Board recommend that EPA support the establishment of a new loan guaranty program?

Methodology

Our deliberations have focused on the potential benefits of creating a new guaranty program, as contrasted with what can be achieved under existing legislation – e.g., by using the loan guaranty authority available to State Revolving Funds (SRFs) or by using the authorization for the Rural Utilities Service (RUS) to guaranty loans made by banks and other eligible lenders. In evaluating the potential incremental benefit of a new loan guaranty program, the Board's primary consideration was whether a new program would stimulate or accelerate environmental activity. A secondary consideration was whether a new program would increase the amount of private money involved in supporting environmental programs.

Recommendation

To date, the Board has not identified an area in which a significant benefit would be realized from the establishment of a new loan guaranty program. However, two areas may warrant further study. First, consideration might be given as to whether existing loan guaranty authority for environmental programs could be more effectively leveraged. Second, additional consideration might be given as to whether a new loan guaranty program targeted at small, unrated borrowers could accelerate environmental activity in that sector.

Discussion

In general, the benefits that could be achieved through the creation of a new loan guaranty program could also be achieved using the existing loan guaranty programs. However, as currently structured, the existing SRF and RUS mechanisms for providing loan guaranties are unused or underutilized. To create a more effective loan guaranty program (either by improving the existing programs or by creating a new program), it would be critical to modify those attributes of the existing programs that have limited loan demand.

Specific considerations regarding the potential utility of a loan guaranty program include:

- For most rated borrowers (which includes many water and sewer systems), there is a well developed and highly competitive private market that provides credit enhancement in the form of municipal bond insurance. Therefore, for such borrowers, absent some sort of additional subsidy, the potential benefit of a new or existing loan guaranty program is limited to eliminating or reducing the cost of obtaining credit enhancement.

- If the requirements for obtaining a loan guaranty add significantly to the borrower's cost or administrative burden (e.g., the federal cross-cutting requirements applicable to SRF loans and guaranties), the benefit of obtaining a loan guaranty would be outweighed by the additional burden of obtaining the guaranty and there would be little, if any, demand.

  - ◈ There would be no demand for SRF loan guaranties for projects that had not otherwise already met the cross-cutting requirements. There are two potential situations in which the opportunity to provide loan guaranties for projects that have already met the cross-cutting requirements could occur:

    - ♦ First, to extend the loan amortization period for projects that have already been qualified to receive federal assistance in order to obtain an SRF interest subsidy. The loan guaranty can be used to further lower debt service by extending the amortization period beyond the period authorized for subsidized SRF loans (20 years except for hardship loans and for Clean Water State Revolving Fund loans in Massachusetts and New York). The loan guaranty would not be offered under Sections 603(d) (1) and 1452 of the Clean Water Act and Section 1452 of the Safe Drinking Water Act, under which loans are statutorily limited to 20-year repayment terms. Rather, implementation would require state programs to operate in conjunction with Section 603(d) (2) and Section 1452 of the respective Acts, which allow for the purchase of municipal debt obligations without any express term limitation.

    - ♦ Second, to guaranty loans for projects which have already met the cross-cutting requirements but for which the amount of SRF assistance has been capped due to a state-imposed limit on the dollar amount of the subsidized borrower loan for any project. In such states, the existing SRF guaranty authority may be significantly underutilized at the present time. To the extent that an entire project has met the cross-cutting requirements, the SRF could easily provide additional assistance for the project in the form of an "AAA" loan guaranty. However, any additional/novel SRF tools should not be made available to states in which there are back-logs for SRF assistance, but where the state has not yet leveraged its SRF program.

  - ◈ In the context of the RUS authorization to provide loan guaranties in the amount of $75 million annually, there has been little demand because under federal tax law, the use of such a "federal" loan guaranty would disqualify the guarantied debt from being issued on a tax-exempt basis.

Thus the benefit of a loan guaranty would be offset by the increased borrowing cost. The RUS program is targeted at very small borrowers and at borrowers who do not otherwise have market access; and the RUS program is exempt from at least some of the cross-cutting requirements (e.g., Davis-Bacon) that apply to SRF loan guaranties.

- Another consideration regarding an additional loan guaranty program is the confusion, particularly to smaller borrowers, caused by a proliferation of different programs. The creation of another program might be more confusing than helpful to many communities. This issue could be addressed by linking any new loan guaranty authority to an existing program.